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No. 192

In the Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ALUMINUM GOODS MANUFACTURING COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

INDEX

	Page
Petition:	
Statement	1
Specification of errors to be urged	4
Reasons for granting the writ	4
Brief in support of petition:	
Opinions below	7
Jurisdiction	7
Question presented, statutes and regulations involved, etc.	7
Argument	8
Conclusion	14
Appendix	15–18

CITATIONS

Cases:	
American Paper Exports v. *Bowers*, 54 F. (2d) 508	13
American Printing Co. v. *United States*, 53 F. (2d) 98	13
Autosales Corporation v. *Commissioner*, 43 F. (2d) 931	5–10
Bogle & Co., W. S., v. *Commissioner*, 26 F. (2d) 771	9
Brewster v. *Gage*, 280 U. S. 327	8
Canal-Commercial National Bank, 22 B. T. A. 541	13
Fidelity Nat. Bank & T. Co. v. *Commissioner*, 39 F. (2d) 58	9
Handy & Harman v. *Burnet*, 284 U. S. 136	10
Lavenstein Corporation v. *Commissioner*, 25 F. (2d) 375	9
Packard Motor Car Co. v. *United States*, 30 F. (2d) 991, certiorari denied, 282 U. S. 848	9
Remington Rand, Inc. v. *Commissioner*, 33 F. (2d) 77, certiorari denied, 280 U. S. 591	11, 12
Rigge National Bank, 17 B. T. A. 615, 57 F. (2d) 980	12
United Publishers' Corporation v. *Anderson*, 42 F. (2d) 781	12
Utica Knitting Co. v. *United States*, 68 Ct. Cls. 77, certiorari denied, 281 U. S. 739	4, 9, 10, 12
Wilmington Steamboat Co. v. *Sturgess*, 52 F. (2d) 210, affirmed, 55 F. (2d) 821	13

127070—39-1

Statutes:

	Page
Revenue Act of 1916, c. 463, 39 Stat. 756, 767—	
Sec. 12	15
Revenue Act of 1917, c. 63, 40 Stat. 300, 305, 307—	
Sec. 206	15
Sec. 213	15
Revenue Act of 1921, c. 136, 42 Stat. 227, 309, 319—	
Sec. 1331	16
Sec. 1303	16
Miscellaneous:	
Regulations 33—	
Art. 147	17
Art. 151	17
Regulations 41, Art. 77	17
Regulations 45, Art. 637	8
Regulations 62, Art. 636	8
Regulations 65, Art. 636	8
Regulations 69, Art. 635	8
Regulations 74, Art. 734	8
Regulations 75, Arts. 31, 38 (b)	8

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v.

ALUMINUM GOODS MANUFACTURING COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

PETITION

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Seventh Circuit, entered on February 25, 1932, reversing the decision of the Board of Tax Appeals. (R. 39.) Petition for rehearing was denied April 4, 1932. (R. 41.)

STATEMENT

The facts found by the Board of Tax Appeals (R. 20–25) may be summarized as follows:

In 1914 respondent, a New Jersey corporation engaged in manufacturing, purchased all the capi-

tal stock of the Aluminum Sales and Manufacturing Company, a New York corporation, (hereinafter referred to as the Sales Company), for $29,749.80, and continued to hold the same during the period herein involved. Thereafter the Sales Company was principally engaged in selling goods manufactured by respondent and was primarily employed as an outlet for respondent's goods. The Sales Company made remittances to respondent from its collections and capital, for goods purchased, maintaining a revolving fund to meet operating expenses. This fund was replenished by recurrent advances from respondent. The business conducted by the Sales Company in Indianapolis was discontinued in 1916 and the New York place of business was discontinued in 1917. The business of the Sales Company during 1917 consisted chiefly of liquidating its assets and no business was transacted by it after that year. Certain assets were taken over by respondent and credited to its open account with the Sales Company. (R. 20–21.) At the close of 1917 the amounts owed by the Sales Company to respondent for advances and merchandise, totaled $47,486.31. Respondent charged off its books a portion of these advances on December 30, 1916, and the balance on December 31, 1917. These sums were not repaid. Respondent charged off on its books the $29,749.80 invested in the capital stock of the Sales Company, a portion on December 31, 1916, and the balance a year later.

So far as the record shows the process of liquidation was not completed before the close of the year 1917. The Sales Company was formally dissolved in February, 1918. (R. 22.)

Up to and including 1916 the respondent and the Sales Company made separate returns for tax purposes. The Sales Company sustained losses for 1914, 1915, and 1916. It sustained an operating loss in 1917 which was allowed by the Commissioner as a deduction in that year.

For the year 1917 respondent filed a separate return for normal tax purposes and a consolidated return with the Sales Company for excess-profits tax purposes. In the year 1917 respondent claimed and petitioner allowed a loss for normal tax purposes consisting of the total of advances to the Sales Company together with the purchase price of the stock, less the value of the equipment and good will received upon liquidation of the Sales Company. A loss was claimed for excess-profits tax purposes consisting of the same figure less the 1917 operating loss. (R. 23.) This the Commissioner disallowed. (R. 23–24.) The Board sustained the determination of the Commissioner. (R. 25–26.) Upon petition for review the Circuit Court of Appeals reversed and remanded the case to the Board of Tax Appeals, holding that the losses in question did not arise from intercompany transactions and were properly deductible from gross income upon the consolidated return for excess-profits tax purposes. (R. 39.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred—

1. In holding that losses sustained when the investment of respondent in the stock of the Sales Company became worthless, and losses arising from advances by the respondent to the Sales Company were deductible upon the consolidated excess-profits tax return of the affiliated corporations for 1917.

2. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision of the court below is in conflict with the decision of the Court of Claims in *Utica Knitting Co.* v. *United States,* 68 C. Cls. 77, certiorari denied, 281 U. S. 739. The court there held that no deduction could be claimed upon a consolidated excess-profits tax return for the year 1917 for losses arising from the stock investment of a parent corporation in a subsidiary and also for an unpaid balance due on open account between the two corporations, when the subsidiary was liquidated during the last month of the taxable year. The similarity in the facts of the *Utica* case and the present case is striking. The court below recognized that the decision in the *Utica* case was contrary to its decision and refused to follow it. (R. 25.)

2. The decision of the court below was erroneous. The court held in effect that the Treasury Regula-

tions, which have consistently required the elimination of intercompany transactions in computing the consolidated net income of affiliated corporations, did not apply to the losses involved in this case, or, if they did, that they were not authorized by the statute. These regulations, sustained by a number of decisions, clearly apply to respondent's losses. The court below also held that the losses sustained by the respondent were deductible, upon its 1917 consolidated return for excess-profits tax purposes upon the theory that liquidation of the Sales Company terminated the affiliation and the losses were therefore sustained after affiliation ended. In so far as the decision of the court below was based on the view that the statutes relating to affiliation apply only to corporations actively engaged in business, it is in conflict with *Autosales Corporation* v. *Commissioner,* 43 F. (2d) 931, 933 (C. C. A. 2d). The mere process of liquidation of the Sales Company did not terminate affiliation between that company and the respondent. Respondent continued to own the stock of the Sales Company after the taxable year and a consolidated return was filed for the entire taxable year 1917. Accordingly the statutory basis for affiliation continued throughout 1917.

3. The question whether in computing net income, intercompany transactions are to be disregarded under circumstances similar to those presented at bar, is one of general importance affecting substantial sums in taxes and a number of taxpayers. This

question is presented upon similar or analogous facts in numerous cases now pending in the Bureau of Internal Revenue, the Board of Tax Appeals, and the courts. The question arises under all the Revenue Acts since the Revenue Act of 1917.

Wherefore, it is respectfully submitted that the petition should be granted.

THOMAS D. THACHER,
Solicitor General.

JULY, 1932.

BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 20–25) is reported in 22 B. T. A. 1. (See also supplemental memorandum opinion, R. 25–26.) The opinion of the Circuit Court of Appeals (R. 36) is reported in 56 F. (2d) 568.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 25, 1932. (R. 39.) Petition for rehearing was denied April 4, 1932. (R. 41.) The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the losses sustained by the respondent in 1917 upon its investment in the stock of the Sales Company and for indebtedness of the Sales Company to respondent were intercompany transactions which are to be disregarded for excess-profits tax purposes upon a consolidated return for 1917.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set forth in the Appendix (*infra*, pp. 15–18).

STATEMENT

A statement of the facts and the errors to be relied upon will be found in the petition.

ARGUMENT

The Revenue Act of 1917 originally made no provision for consolidated returns by affiliated corporations. Section 240 of the Revenue Act of 1918 provided expressly for consolidated returns by affiliated corporations and Section 1331 of the Revenue Act of 1921 (*infra*, p. 16) provided that for the purpose of determining excess-profits taxes Title II of the Revenue Act of 1917 "shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917."

The Treasury Regulations under the Revenue Act of 1918 and under subsequent Acts provide in substance that in determining the consolidated taxable net income of affiliated corporations intercompany transactions must be eliminated. (Article 637, Regulations 45; Article 636, Regulations 62; Article 636, Regulations 65; Article 635, Regulations 69; Article 734, Regulations 74; Articles 31, 38 (b), Regulations 75.) This consistent administrative interpretation of the Revenue Acts has implied legislative approval and is to be given the force of law. *Brewster* v. *Gage*, 280 U. S. 327. The principle that intercompany transactions are to be

eliminated in determining consolidated net income of affiliated corporations has also received repeated judicial approval. *Utica Knitting Co.* v. *United States,* 68 Ct. Cls. 77, certiorari denied, 281 U. S. 739; *Packard Motor Car Co.* v. *United States,* 39 F. (2d) 991, 997 (Ct. Cls.), certiorari denied, 282 U. S. 848; *Lavenstein Corporation* v. *Commissioner,* 25 F. (2d) 375 (C. C. A. 4th); *W. S. Bogle & Co.* v. *Commissioner,* 26 F. (2d) 771 (C. C. A. 7th); *Fidelity National Bank & T. Co.* v. *Commissioner,* 39 F. (2d) 58 (C. C. A. 8th).

While conceding that intercompany transactions, which resulted in gain to one and loss to the other of two affiliated corporations, should be eliminated, the court below held that the losses which respondent sought to deduct were not of that character but that if the Treasury Regulations requiring the elimination of intercompany transactions applied to respondent's losses, they were unauthorized. It is clear that the interpretation which the court below sought to place upon the Regulations was not justified, for the Regulations required the elimination of all intercompany transactions.

The loss sustained by respondent in the investment in stock of its subsidiary, as well as the loss sustained through the failure and inability of the subsidiary to pay its indebtedness to respondent, clearly arose out of intercompany transactions. In an almost precisely similar situation the Court of Claims in *Utica Knitting Co.* v. *United States, supra,* held that the loss arising out of investment

in stock of a subsidiary, and out of indebtedness due from the subsidiary to the parent corporation which it could not pay, constituted losses arising out of intercompany transactions which were to be eliminated in determining the income of affiliated corporations for excess-profits tax purposes. The decision of the court below is squarely in conflict with the decision in the *Utica Knitting Co.* case, *supra*, and the court below recognized that it was departing from the decision in that case.

The court below also held that liquidation of the Sales Company *ipso facto* terminated the affiliation of the two companies, apparently on the ground that the statute governing affiliated returns contemplated its application to active companies only. The decision upon this point is directly in conflict with the decisions in the *Utica Knitting Co.* case, *supra*, and *Autosales Corporation* v. *Commissioner*, 43 F. (2d) 931, 933 (C. C. A. 2d). There is nothing in the statutes or regulations which suggests that while the ownership or control upon which affiliation depends continues, it is necessary that all of the affiliated corporations should be actively engaged in business. *Autosales Corporation* v. *Commissioner, supra*, p. 933. In *Handy and Harman* v. *Burnet*, 284 U. S. 136, this Court said (p. 140):

> The purpose of §240 [of the Revenue Act of 1918] was, by means of consolidated returns, to require taxes to be levied according to the true net income and invested capital resulting from and employed in a single business enterprise, even though it was conducted by means of more than one corporation.

The fact that one branch of the enterprise is in course of liquidation does not end affiliation. The liquidation, in the present case, consisted merely in the transfer of the subsidiary's assets to the respondent. The respondent continued to hold the subsidiary's stock, which was neither sold nor surrendered up for cancellation. The parent company had merely drawn to itself the assets of its subsidiary and could have restored what it had taken away. The business enterprise was single as it had been since affiliation and the intercorporate transactions could not add to or subtract from the true income of the affiliated unit.

There are obvious practical difficulties attendant upon the view that liquidation terminates affiliation, which are indicated by the present record. Liquidation is a term of somewhat loose connotation. The present record does not show when liquidation occurred or was completed, with any degree of certainty. Dissolution, on the contrary, ends the corporate life of one of the affiliates. Affiliation ends then, for there ceases to be a corporation which can be a party to the affiilation. But short of that definitive event and in the absence of a disposition of ownership or control to outside interests, the status of affiliation continues.

The court below referred to a number of cases as supporting its conclusion, all of which are believed to be distinguishable.

In *Remington Rand, Inc.*, v. *Commissioner* (C. C. A. 2d), 33 F. (2d) 77, certiorari denied, 280 U. S.

591, the parent corporation sold the stock of its subsidiary to outside interests, thereby terminating the affiliation, and a *separate* return was filed for the ensuing period. The Board of Tax Appeals held that the transaction resulted in neither gain nor loss. The Circuit Court of Appeals reversed, observing that the sale terminated the affiliation, which resulted from the purchase of the stock; that both the purchase and sale took place outside the period of affiliation and were made by the seller for its own account, not for the account of the affiliated group. *Utica Knitting Co.* v. *United States, supra,* is in effect distinguished in the opinion in the *Remington Rand* case as follows (p. 78):

> *Whatever may be the rule where affiliation continues after the sale,* under the facts of the instant case we think the board erred in ruling that neither taxable gain nor deductible loss resulted to the parent company from the sale of the stock. (Italics ours.)

In *United Publishers' Corporation* v. *Anderson* (S. D. N. Y.), 42 F. (2d) 781, there was also a sale of the stock to outside interests, and the court, upon authority of *Remington Rand, Inc.,* v. *Commissioner, supra,* held that the resulting loss was deductible on a *separate* return for the ensuing period. *Riggs National Bank,* 17 B. T. A. 615, was affirmed 57 F. (2d) 980 (C. C. A. 4th). There a merger, equivalent to dissolution of the subsidiary, took place and the shares of the subsidiary stock owned by the parent corporation were surrendered

in exchange for assets. The loss was allowed as a deduction against *separate* income for a period subsequent to affiliation. In *Canal-Commercial National Bank,* 22 B. T. A. 541, there was an actual dissolution on the same day that the liquidation occurred. The gain realized was solely that of the parent company and one which was not reflected in the consolidated income of the affiliated corporations. (P. 550.) *American Printing Co.* v. *United States,* 53 F. (2d) 98 (D. Mass.), is likewise readily distinguishable. There the subsidiary ceased to do business on December 31, 1917, and was dissolved by decree of court "soon thereafter." (P. 98.) The taxable year was 1919, and affiliation had apparently ceased some time before the beginning of that year. The decision in *American Paper Exports* v. *Bowers,* 54 F. (2d) 508 (C. C. A. 2d), has no apparent bearing upon the question. In that case the court held merely that a single consolidated return should be filed for the entire year in case a parent corporation, organized during the course of the year, becomes affiliated with a subsidiary already in existence and active from the beginning of the year.

In *Wilmington Steamboat Co.* v. *Sturgess* (N. J.), 52 F. (2d) 210, affirmed, 55 F. (2d) 831 (C. C. A. 3d), the District Court indicated that if there was any loss to one of several affiliated corporations it could be deducted for excess profits tax purposes because affiliation ceased upon liquidation of one of the affiliates, but held as a matter

of fact that there was no loss. The Circuit Court of Appeals affirmed the determination on the question of fact and did not discuss the termination of affiliation.

CONCLUSION

The decision of the Circuit Court of Appeals is erroneous, and in view of the general importance of the question presented and the existence of a conflict of decisions, the petition for certiorari should be granted.

Respectfully submitted.

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JULY, 1932.

APPENDIX

Revenue Act of 1916, approved September 8, 1916, c. 463, 39 Stat. 756, 767:

SEC. 12. (a) In the case of a corporation, * * * organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

* * * * *

Second. All losses actually sustained and charged off within the year * * *.

Revenue Act of 1917, c. 63, 40 Stat. 300, 305, 307:

TITLE II.—WAR EXCESS PROFITS TAX

SEC. 206. That for the purposes of this title the net income of a corporation shall be ascertained and returned * * * for the taxable year upon the same basis and in the same manner as provided in Title I of the Act * * * approved September eighth, nineteen hundred and sixteen, as amended by this Act, * * *.

SEC. 213. That the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall make all necessary regulations for carrying out the provisions of this title, * * *

Revenue Act of 1921, approved November 23, 1921, c. 136, 42 Stat. 227, 309, 319:

CONSOLIDATED RETURNS FOR YEAR 1917

SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

(b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided,* That such corporations or partnerships were engagel in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. * * *

(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

SEC. 1303. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act.

* * * * *

Regulations 33 (Income Tax), promulgated under the Revenue Acts of 1916 and 1917:

> ART. 147. *When* [losses] *deductible.*—The deduction for losses must represent losses * * * which were charged off and actually sustained within the year as evidenced by closed and completed transactions.
>
> * * * * * *
>
> ART. 151. *Bad debts.*—Losses which may be properly deducted from gross income on account of bad debts or doubtful accounts are those losses which have been definitely ascertained to have occurred and which were charged off during the year for which the return is made. * *

Regulations 41 (War Excess Profits Tax), promulgated under the Revenue Act of 1917:

> ART. 77. *When affiliated corporations must furnish information as to intercorporate relations.*—For the purpose of the excess-profits tax every corporation will describe in its return all its intercorporate relationships with other corporations with which it is affiliated, and will furnish such information in relation thereto as will enable the Commissioner of Internal Revenue to compute the amount of the tax properly due from each corporation on the basis of an equitable and lawful accounting.
>
> For the purpose of this regulation two or more corporations will be deemed to be affiliated (1) when one such corporation owns directly or controls through closely affiliated interests or by a nominee or nominees, all or substantially all of the stock of the other or others, or when substantially all of the stock of two or more corporations is owned by the same individual or partnership, and

both or all of such corporations are engaged in the same or a closely related business; or (2) when one such corporation (a) buys from or sells to another products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or (b) in any way so arranges its financial relationships with another corporation as to assign to it a disproportionate share of net income or invested capital.

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